Dykema | Business Services Alert

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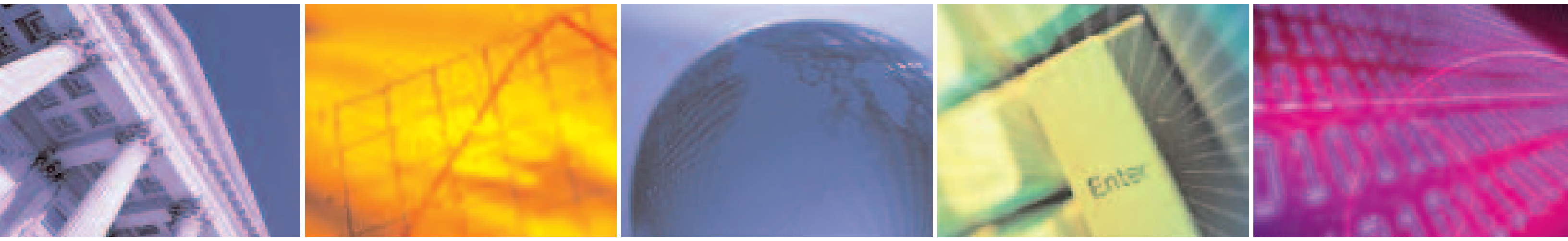

The Red Flag Rules Are Here—Are You In Compliance?

To address the significant problem of identity theft, Congress has mandated the creation of "Red Flag Rules," and you may be surprised to learn that these rules could apply to any company, business, or governmental entity that extends credit, bills in arrears or arranges for credit for others. This Dykema Alert tells you about these rules, and provides some of the basic "rules of the road." Please contact Dykema to learn how these rules might apply specifically to your company.

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What Are the Red Flag Rules?

The Red Flag Rules were promulgated pursuant to the Fair Credit Reporting Act ("FCRA") to help combat identity theft. Pursuant to the Red Flag Rules, covered entities are required to develop and implement a written identity theft prevention program (the "Program") to detect, prevent and mitigate identity theft in connection with the opening or maintenance of certain accounts. Because the Program is required to identify indicators of a possible risk of identity theft, such indicators being "red flags," these regulations are commonly referred to as the "Red Flag Rules." The mandatory compliance date for the Red Flag Rules is November 1, 2008[1].

Do the Red Flag Rules Apply to Me?

The Red Flag Rules apply to financial institutions and creditors. A "creditor" is defined as a "person who regularly extends, renews or continues credit" as well as "any person who arranges for the extension, renewal, or continuation of credit." Since "credit" is defined as the "right granted by a creditor to a debtor to defer payment of a debt or to purchase property or services and defer payment therefor," anyone who bills in arrears for services may also be considered a creditor. The Red Flag Rules are broad enough to include lenders such as banks, finance companies and automobile dealers, as well as mortgage brokers, utility companies and telecommunication companies. Local units of government and nonprofit entities may also be creditors for purposes of the Red Flag Rules.

It is not enough, however, to merely be a creditor or financial institution: the covered entity must also establish or maintain "covered accounts." A "covered account" is "any account offered or maintained for personal, family or household purposes that involves or is designed to permit multiple payments or transactions."

A "covered account" is also "any account for which there is a reasonably foreseeable risk to customers or to the safety and soundness of the financial institution or creditor from identity theft." Thus, under this second "prong," a covered account may also include accounts established or maintained for a creditor's business customers. Examples of covered accounts include credit card accounts, checking accounts and savings accounts, as well as mortgage loans, automobile loans, and margin loans. Cell phone accounts and utility accounts are also considered covered accounts.

In most cases, the mere fact that you accept credit cards does not make you a creditor. That said, if you arrange for someone's credit as a broker or take credit card applications for a third party lender, you are likely a creditor under the Red Flag Rules. If you bill in arrears for services or goods or if you allow consumers to defer their payments, then you will also likely be considered a creditor. The scope of the Red Flag Rules is broad enough to include almost any type of business as well as nonprofit and governmental entities.

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[1] On October 22, 2008, the FTC announced that it would suspend enforcement of the Red Flag Rules against entities subject to its jurisdiction until May 1, 2009. As of the date of this publication, none of the other federal agencies that jointly issued the Rules with the FTC has announced any similar suspension of enforcement and it is not anticipated that they will do so.

In short, if you offer credit terms to your customers or you bill your customers in arrears or you are involved in arranging credit for others, you are most likely subject to the Red Flag Rules.

If I Am Required to Comply, What Must I Do?

Each covered entity that offers or maintains one or more covered accounts must develop and implement a written Program. The Program must be designed to detect, prevent, and mitigate fraud arising from identity theft. There are five steps in the process:

First, **identify all covered accounts and conduct an initial risk assessment**. For each covered account you should identify possible points in a transaction where identity theft or fraud by identity theft could occur. In conducting your assessment you should identify any incidents in which there has already been fraud by identity theft. You should also identify any third party service providers that provide services in connection with your covered accounts.

Second, **identify relevant Red Flags** for the covered accounts that you offer or maintain. For example, your company may be exposed to the risk of fraud by identity theft when a customer opens an account and uses stolen identification. An identity thief may also attempt to steal customer information from you by requesting information on someone else's account. Red Flags may appear in these instances when valid identification cannot be presented. Similarly, a Red Flag may present itself when information in an application does not match information in a credit report. The federal agencies have identified 26 common Red Flags, but covered entities are encouraged to identify their own list of pertinent Red Flags.

Third, **determine what policies and procedures you will implement** to detect a Red Flag when presented. For example, your financing or accounting office may detect Red Flags when reviewing credit or account opening applications or when reviewing consumer credit reports. The accounting office may also require a caller to answer certain "challenge questions" such as the maiden name of the account holder's mother whenever a request is made to access account information.

Fourth, **determine what actions will be taken when a Red Flag is detected**. The responses may range from increased monitoring to contacting the customer directly in order to resolve inconsistencies to notifying law enforcement officials. It is also possible that the company will determine that no response is warranted at all under the particular circumstances.

Fifth, **determine who will oversee Program implementation**. Program oversight should be handled by someone in senior management or by a committee established by the Board of Directors. The person or committee should establish training for staff and should be required to provide ongoing evaluation of the Program to determine whether the Program is effective in complying with the Red Flag Rules. A report should be given to the Board of Directors at least annually regarding the Program.

Once these factors have been quantified and policies and procedures have been established, the Program must be put into written form and approved by the company's Board of Directors.

What Are The Penalties If I Fail To Comply?

Failure to comply with the Red Flag Rules may subject a covered entity to an enforcement action by the appropriate federal agency which has jurisdiction over the financial institution or creditor. The appropriate Agency has such procedural, investigative and enforcement powers necessary to enforce compliance with the Red Flag Rules. Additionally, the covered entity may be subject to penalties of up to $2,500 per violation.

Where Do I Go From Here?

If you have any questions regarding the Red Flag Rules, FCRA or the FACT Act, contact your attorney at Dykema who can put you in contact with a member of Dykema's Consumer Financial Services Team. Dykema's Consumer Financial Services Team consists of nationally recognized experts in the field of consumer finance. They can assist you in determining whether your company is subject to the Red Flag Rules and can assist you in identifying the Red Flags relevant to your business. They can also assist you in establishing the policies and procedures to detect and respond to the Red Flags and in drafting your Program.

If you have any questions regarding the Red Flag Rules or this Alert, you may contact Richard Gottlieb (312-627-2196; rgottlieb@dykema.com), director of Dykema's Consumer Financial Services Team or Lee Logan (517-374-9158; wlogan@dykema.com), the author of this Alert.